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TAGS: EFIN ECON RP
SUBJECT: PAIN NOW, WORSE PAIN LATER FOR THE PHILIPPINE ECONOMY

REFS: A) Manila 2340, B) Manila 2174, C) Manila 1050

SENSITIVE BUT UNCLASSIFIED

¶1. (SBU) Summary: The impact of the U.S. slowdown and global financial problems on the Philippines has so far been felt mostly through the fall of the stock market and of the value of the peso. Real economic pain, though, is coming. Contacts in business and government tell us they are bracing for serious setbacks. While there is no expectation of a banking or financial crisis, effects will likely include scaling down of production and layoffs in the electronics and semiconductor sectors, a significant slowdown in construction, and slower growth in remittances from Filipinos overseas. Revenue challenges and increasing costs of borrowing will constrain fiscal policy. Slower GDP growth will constrict employment opportunities and poverty will likely increase for the Philippines's rapidly growing population. End Summary.

Direct Exposure to Problematic Investments Limited...

¶2. (U) During the initial months of financial turbulence, the Philippines has been shielded from the most direct effects of financial troubles in the United States (Refs A and B). Its relatively inward-looking banking and insurance industries have relatively little exposure to foreign financial instruments, generally placing over 90% of their loans and domestic investments. Reinforcing domestic financial stability were remittances from overseas Filipino workers, which have been growing by more than 17% year-on-year thus far and are expected to contribute more than $16 billion to the Philippine economy during 2008.

Stocks/Peso Suffer Most Obvious Setbacks...

¶3. (U) The more immediate and significant effects of the external financial shock have thus far been on the Philippine stock and currency markets. For the first time since December 2006, the Philippine peso fell back to 49 pesos to U.S. dollar territory during the last week of October, after peaking at around 40 to the U.S. dollar this past February, prompting the Central Bank to dip into its $37 billion stock of reserves. On November 7, the peso closed at 48.81, 3.9% weaker than at the end of September 2008 and 18.2% weaker from the end of 2007.

¶4. (U) The local stock market has been volatile since mid-September. On Monday, October 27, the Philippine Stock Exchange composite index experienced a 12.3% one-day decline to 1713.83, slipping to its lowest level in more than four years. Stock Exchange officials imposed a mandatory 15-minute halt to trading in order to stop a wave of panic selling (a "circuit breaker" strategy agreed upon by stock exchange members should the index fall by 10%

or more from its previous day's close). The main index of the Exchange slipped by another 0.5% to 1704.41 on October 28, before rising in subsequent days in response to the Federal Reserve's announcement of an interest rate cut. At the close of trading on November 7, the index stood at 1921.34, compared to 3621.60 at the end of 2007 (a 46.9% drop year-to-date). The stock index has declined by more than 26% over the past six trading weeks alone.

¶5. (SBU) Though systemic risk seems manageable at this point, there may be specific companies or financial institutions where risk is concentrated. One example may be the Lopez group of companies, owners of the electricity distribution company for Manila, which has high dollar-denominated debts. Between devaluation of the peso and the decline of equity prices, the Lopez group has seen the value of the collateral for its loans fall to 10% of outstanding loans.

...But Adverse Impact on Real Economy Emerging
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¶6. (SBU) Though government statements about the impact of global developments on the Philippines have been predictably sanguine, businesspeople are nervous and pulling back. Jaime Zobel de Ayala, one of the most respected businessmen in the country, told Ambassador that his companies are pulling back assets and minimizing risk. Ernie Santiago, President of the industry association representing the semiconductor and electronics industries of the country (the largest concentration of U.S. investment) told Econoff that association members will be cutting back production in coming months. They have scheduled a meeting of their members to discuss how to deal publicly with the significant layoffs participants in the industry will have to announce soon.

¶7. (U) Contacts in the construction and tourism industries have also expressed to us their concern about their sectors. Construction, in particular, expects to be hit by cutbacks in the private sector and in government investment spending, as well.

¶8. (SBU) One of the President's most trusted economic advisors, Joey Salceda, told us that he expects the impact on the Philippines to be very significant. He expects 2008 growth to fall by at least half it's 2007 three-decade high of 7.2 percent. He predicts overseas worker remittances, which have seen growth approaching 20 percent per year recently, will slow to single-digit growth over the coming year. Increasing tax revenue will be challenging. The "flight to quality" by investors has already begun to exert upward pressure on domestic and foreign interest rates and may tighten the Government of the Philippines's access to financing. At a time when he would like to advise President Arroyo to spend and stimulate the economy, most likely there would be not choice but to cut spending on infrastructure.

¶9. (SBU) In a separate meeting, Finance Secretary Gary Teves agreed with Salceda's conclusions, stating that he is facing an increasingly tough budget cycle, with a number of factors exacerbating revenue pressures in an already challenging environment. The corporate income tax rate (raised from 32% to 35% under the reformed value added tax law as a form of "burden sharing") falls to 30% in 2009. A tax relief measure signed into law in response to high food and fuel inflation took effect in July 2008, exempting minimum wage earners from income tax and increasing personal deductions.

Impact on Poverty

¶10. (SBU) While lower prices for energy and food (the price of rice is now half what it was at its peak earlier this year) will provide some relief, poverty will certainly increase with the slowing of the economy. Salceda predicted 310,000 job losses, including 50,000 for overseas Filipino workers, - about 1% of total employment in the Philippines. Combined with more than 1 million new entrants in the Philippine job market annually, the unemployment rate could inch up to between 9%-10% over the coming year, from 7.6% currently. Measurements of poverty and hunger are both likely to increase as a

result.

Recent GRP Responses

¶11. (U) On October 23, the Central Bank issued Circular 627, launching a dollar-denominated repurchase facility to help ease the "uneven distribution" of foreign exchange among banks and temper pressure on the peso. On October 23 and 31, the monetary authority also issued Circulars 626 and 628, respectively, providing guidelines for financial institutions to reclassify certain financial assets from categories recorded at fair market value to categories recorded at amortized cost. Allowing the reclassification of non-derivative financial assets conforms with revisions issued in October 2008 by the International Accounting Standards Board -- purposely to help promote confidence in financial markets by tempering potentially sharp deteriorations in balance sheets and incomes from the current global financial turbulence. As additional regulatory relief, the Philippine monetary authority also allowed the reclassification, until mid-November 2008, of credit link notes and similar products underpinned by Republic of the Philippines bonds. In response to emerging tightness in the interbank credit market, the Philippine Central Bank announced on November 7 a two percentage point cut in required reserve requirements effective November 14, and doubled resources under its rediscounting facility to 40 billion pesos (about $816 million).

¶12. (U) Salceda told us that, given limits to government spending, the government would attempt to prioritize strictly its budget for ¶2009. In particular, he saw increases focusing on agriculture, including more purchases of rice from farmers (buying high and selling low in order to subsidize both producers and consumers), education (scholarships) and healthcare. He said that President Arroyo continues to support the Doha Round. For his part, he said, "A new WTO deal would do more than all the bailouts in helping the real economy, as it would optimize the positive impacts of stimulus packages."

Comment: Combating Poverty Still on the To Do List
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¶13. (U) The Philippines is likely to weather the downturn

reasonably well, mostly thanks to the stabilization of the macroeconomic situation -- the most important accomplishment of the Arroyo government. Nonetheless, the desperate poverty which afflicts about 45% of the population of this country (measured against the $2/day international poverty line) will worsen (Ref C). The need for selected reforms and for further opening of the economy to combat poverty will continue to grow.

Kenney